SCOUNDRELS IN THE C-SUITE

HOW SHOULD THE BOARD RESPOND WHEN A CEO'S BAD BEHAVIOR MAKES THE NEWS?

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INTRODUCTION

The board of directors has a duty to monitor the corporation on behalf of shareholders. This includes the obligation to investigate credible allegations that management has engaged in activity that is not in the interest of the company or its shareholders. If verified, the board should (and normally will) take corrective action, including termination, required leave of absence, reduction in pay, and changes to policies or procedures for executive conduct.

Although the appropriate response to illegal activity is likely to be very clear, it is less obvious what actions directors should take when the CEO engages in behavior that is questionable but *not* illegal—for example, a CEO making controversial public statements, having relations with an employee or contractor, or developing a reputation for being rude, overbearing, or verbally abusive. The decision becomes more important when these actions are picked up by the news media, bringing public attention to the executive behavior. In this case, the board must decide whether and how to investigate, and whether or not to address the matter publicly or privately. Equally important is the board's assessment of whether CEO misbehavior will impact the broader organization and shareholder value. This includes determining the scope of the CEO's actions, and whether the actions are indicative of systemic or potentially widespread cultural problems that adversely impact shareholders.

Concerns about the potential for bad behavior to spread are explored in many research disciplines. Studies of corporate illegality suggest that companies that engage in misbehavior tend to exhibit repeated violations over time, implying that corporate misbehavior can become persistent.[1] Research also finds that the behavior of individuals within an organization is influenced by the "tone at the top" and that, when left uncorrected, misbehavior can spread.[2]

CEO MISBEHAVIOR

It is difficult to accurately determine the frequency with which CEOs misbehave or the steps that boards take in response to CEO misconduct. First, it is not clear what percentage of misconduct is reported publicly and what remains private. For example, in recent years, news stories have highlighted multiple incidents of CEOs who have misrepresented educational credentials on their resumes or biographies.[3] However, it is unknown how many times similar incidents occur that remain unreported and presumably dealt with in a private fashion at other corporations. Second, clear parameters do not exist to identify questionable behavior that should be of concern to board members. For example, should the board investigate allegations that a CEO is "abrasive" or engages in "tirades"?[4] What about allegations of "arrogance" or "hubris"?[5]

Still, pressure on a board to act increases when stories of CEO conduct are picked up by the media. Valid or not, allegations can spread virally, and references to prior occurrences can resonate in news stories years after they initially occurred—with a lingering effect on corporate reputation.[6]

To examine how corporations handle allegations of CEO misbehavior, we conducted an extensive review of the news media between 2000 and 2015. We identified 38 incidents where a CEO's "bad behavior" garnered a meaningful level of media coverage (defined as more than 10 unique news references).[7] These incidents can be categorized as follows (see Exhibit 1):

- 34 percent involve reports of a CEO lying to the board or shareholders over personal matters—such as a drunken driving offense, prior undisclosed criminal record, falsification of credentials, or other behavior or actions.
- 21 percent involve a sexual affair or relations with a subordinate, contractor, or consultant.
- 16 percent involve CEOs making use of corporate funds in a manner that is questionable but not strictly illegal.
- 16 percent involve CEOs engaging in objectionable personal behavior or using abusive language.
- 13 percent involve CEOs making controversial statements to the public that were offensive to customers or social groups.

Media coverage of CEO misconduct is significant. Reports of these actions were included in over 250 news stories each, on average. Furthermore, reports were persistent, with references made to the CEO's actions 4.9 years on average after initial occurrence. For example, news stories continue to make reference today to former American Apparel CEO Dov Charney's odd behavior of walking around the company's offices in his underwear, even though it was first reported over 10 years ago.

Shareholders react negatively to news of CEO misconduct, with share prices declining by a market-adjusted 3.1 percent (1.1 percent median) over the 3-day trading period before, including, and after the initial news story.[8] For example, Hewlett Packard stock fell almost 9 percent over a 3-day period following reports that former CEO Mark Hurd had a personal relationship with a female contractor. However, stock price reactions are not uniformly negative. Eleven out of the 38 companies in our sample exhibited *positive* abnormal stock price returns when CEO misbehavior made the news. Perhaps unexpectedly, there is no discernable relationship between the *type* of behavior and stock price reaction. (However, a small sample size makes it difficult to reliably measure this association.)

Corporations engage in a variety of responses to allegations of CEO misconduct. The most common is a press release or formal statement on the matter. This occurred 84 percent of the time. In 71 percent of cases, a spokesperson provided direct commentary to the press. Board members were much less likely to speak to the media, making direct comments only 37 percent of the time.[9] In over half of cases (55 percent), the board of directors was known to initiate an independent review or investigation. The board is most likely to announce an independent review in cases of potential financial misconduct. However, the willingness of an individual director to discuss the matter directly with the press does not appear to be associated with the type of behavior involved or the "severity" of the CEO's actions.

Among the sample, it was more likely than not that the CEO was eventually terminated for his or her actions: 58 percent of incidents resulted in termination.[10] Terminations occurred across all categories of alleged behavior. Questionable financial practices was the only category of behavior that almost uniformly resulted in termination; all other behaviors—including allegations of lying to the board or shareholders, expressing controversial views, personal relations with employees, and exhibiting objectionable language or behavior—resulted in both outcomes (termination and retention) across our sample. Even behavior as straightforward as falsifying information on a resume was treated differently by different boards.

Among CEOs who were eventually fired for their actions, the time to termination varied widely, ranging from 9 years following initial media coverage to 20 days prior. (The CEO of Stryker was terminated *before* reports of his extramarital affair with a former employee made the news; the company initially announced that the CEO stepped down "for family reasons"). Eleven CEOs were terminated the same day that the CEO's behavior made the news. Shareholder reaction to termination is muted, with a mean 0.8 percent decline and median 0.1 percent increase in stock price.

In one-third of cases (32 percent), the board took actions other than termination in response to CEO misconduct. These actions included stripping the CEO of the chairman title, removing the CEO from the board, amending the corporate code of conduct, reducing or eliminating the CEO bonus, other director resignation, and other changes to board structure or composition.

Finally, corporations experience a wide range of ramifications as a result of CEO misconduct. Approximately one-third (34 percent) faced additional fallout including a change in marketing, loss of a major client, federal investigation, shareholder or federal lawsuit, or shareholder action such as a proxy battle. It is unclear whether CEO misbehavior was symptomatic of broader cultural or organizational deficiencies, although it is worth noting that 45 percent of companies in the sample experienced a significant unrelated governance issue following the event, such as an accounting restatement, unrelated lawsuit, shareholder action, or bankruptcy.

The implications for the executive are also unclear. Three CEOs in the sample were reported to resign from other boards because of their actions. Two CEOs who were terminated were subsequently rehired by the same company.[11] Many continued in their position, were hired by other corporations or investment groups, or there is no notable news of what happened to them professionally.

As for whether CEOs who misbehave are recidivists, 21 percent of individuals in the sample were reported to have engaged in previous or subsequent questionable behavior, including allegations of sexual harassment, insider trading, and other infractions, felonies, or misdemeanors.

WHY THIS MATTERS

1. The media widely and actively reports allegations of personal misconduct, and because of their prominence, CEOs who engage in bad behavior are an attractive target for news coverage. What is the duty of the board of directors to pursue reports of misconduct, particularly in cases where behavior is not explicitly illegal and shareholders have suffered no apparent loss? When are allegations serious or credible enough

to merit boardroom attention? What steps should boards take in response?

2. The personal conduct of the chief executive officer is an important element of leadership, and the "tone at the top" established by this individual has broad ramifications for corporate culture and performance. How can the board assess the impact of CEO misconduct on the organization broadly? How can they tell whether misconduct is confined to the individual or is widespread?
3. In many cases, the board of director is not the first within an organization to learn of CEO misbehavior and will respond only after reports of misconduct become widespread. However, mechanisms exist for the board to detect misconduct at earlier stages, including confidential workplace surveys, third-party websites (such as GlassDoor), and independent social media listening tools. Should the board be more proactive in employing these tools for early signs of CEO and employee misconduct? ■

1 Seminal studies include Edwin H. Sutherland, *White Collar Crime* (New York: Holt, Reinhart & Winston, 1949); Edwin H. Sutherland, *White Collar Crime: The Uncut Version* (New Haven: Yale University Press, 1983); and Marshall B. Clinard and Peter C. Yeager, *Corporate Crime* (New York: The Free Press, 1980). Among organizational researchers, Frank, Lynch, and Rego (2009) find that companies that engage in aggressive financial reporting practices continue to do so over time. They also find that aggressive financial reporting is associated with aggressive investment, financing, and operating policies. Biggerstaff, Cicero, and Puckett (2015) find that companies whose CEOs engage in stock option backdating are more likely to manipulate earnings and engage in financial reporting fraud. See Mary Margaret Frank, Luann J. Lynch, and Sonja Olhoft Rego, "Are Aggressive Reporting Practices Associated with Other Aggressive Corporate Policies?" *Social Science Research Network* (2009), available at: http://ssrn.com/abstract=1066846; and Lee Biggerstaff, David C. Cicero, and Andy Puckett, "Suspect CEOs, Unethical Culture, and Corporate Misbehavior," *Journal of Financial Economics* (2015).

2 See Blake E. Ashforth, Dennis A. Gioia, Sandra L. Robinson, and Linda K. Treviño, "Re-Viewing Organizational Corruption," *Academy of Management Review* (2008); and Ricky W. Griffin and Yvette Lopez, "'Bad Behavior' in Organizations: A Review and Typology for Future Research," *Journal of Management* (2005).

3 For example: "MGM CEO to Retire Amid Credentials Dispute," *Reuters News* (November 13, 2008); John Gittelsohn, "Broadcom, Microsemi Execs Said to Falsify Resumes," *The Orange County Register* (December 3, 2008); and Julianne Pepitone, "Yahoo CEO Scott Thompson Caught Padding His Resume," *CNN Wire* (May 3, 2012).

4 "Jewelry Boss a Meanie," *New York Post* (July 20, 2015); Evelyn Nussenbaum, "Tirades Her Tool for Tight Control," *New York Post* (December 1, 1999).

5 Carol Hymowitz, "Business Leaders Face a Grassroots Demand for a Lot Less Hubris," *The Wall Street Journal* (March 9, 2004); Alan Murray, "A Tale of Two CEOs: How Public Perception Shapes Reputation," *The Wall Street Journal* (July 6, 2006).

6 See David F. Larcker, Sarah M. Larcker, and Brian Tayan, "Monitoring Risks Before They Go Viral: Is It Time for the Board to Embrace Social Media?" Stanford Closer Look Series (April 5, 2012); and David F. Larcker, Sarah M. Larcker, and Brian Tayan, "Josh Hardy and the #SaveJosh Army: How Corporate Risk Escalates and Accelerates Through Social Media," Stanford Closer Look Series (April 14, 2014).

7 Research performed by the authors, based on keyword searches of all media sources included in the Factiva database. Data collected on CEOs only; other executives were excluded. Searches included the words "CEO" or "chairman" in proximity to a wide set of potential behaviors, captured by 72 terms and their grammatical derivatives. Examples include: abusive, adultery, affair, alcoholism, belligerent, bully, conceal, conspiracy, crude, cut-throat, demeaning, disrespectful, drunk, greedy, harass, immoral, imperious, inconsiderate, intimidate, jerk, lewd, lying, manipulate, philander, prostitute, rant, ridicule, romantic, rude, ruthless, scoundrel, screams, self-promotion, sex, threatens, tyrannical, uncaring, unethical, unreasonable, withhold, and yell.

8 Calculations by the authors.

9 Direct comments are those made outside of the formal corporate statement or press release.

10 Note that a decision to define a resignation as voluntary or involuntary is subject to discretion. CEO departures are typically described as resignations or retirements. We categorize a CEO departure as a termination when it occurs coincidental with initial reports of misconduct or following reports of public pressure on the board to act.

11 One CEO was the founder, the other a significant shareholder of the firm. The first (the CEO of First Marblehead) was fired for giving expensive gifts to employees of a major client, which was seen as unethical and potentially creating conflicts of interest even though he used personal and not corporate funds; he was rehired 3 years later to improve the company's performance. The second (the former CEO of Restoration Hardware) was terminated for having a sexual relationship with an employee; he was rehired one year later to lead a strategic change.

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EXHIBIT 1 — INCIDENTS OF CEO MISBEHAVIOR IN THE PRESS

Descriptive statistics	Count	Frequency
Incidents of misbehavior	38	
Categories of misbehavior		
Lied to the board, shareholders, etc.	13	34%
Had sexual affair or relations	8	21%
Engaged in questionable financial practices	6	16%
Used objectionable language / Exhibited objectionable behavior	6	16%
Expressed controversial views publicly	5	13%
News stories reporting (Factiva hits)		
Mean	258	
Median	115	
Days / years in the news		
Mean	1,793 days 4.9 years	
Median	1,501 days 4.1 years	
Stock price reaction to initial report (3-day market-adjusted)		
Mean	-3.1%	
Median	-1.1%	

EXHIBIT 1 — CONTINUED

Descriptive statistics	Count	Frequency
Company response to media		
Issued press release addressing issue	32	84%
Spokesperson provides comments to press	27	71%
Director provides comments to press	14	37%
CEO terminated because of issue		
Yes	22	58%
No	16	42%
Time to fire CEO (days)		
Mean	375	
Median	0	
High	3,272	
Low	(20)	
Same day	11	
Stock price reaction to initial report (3-day market-adjusted)		
Mean	-0.8%	
Median	0.1%	

EXHIBIT 1 — CONTINUED

Descriptive statistics	Count	Frequency
Other actions and outcomes		
Board initiated an independent investigation	21	55%
Other board action or response	12	32%
Other fallout from issue	13	34%
Company experiences unrelated governance issue following event	17	45%
CEO engages in previous or subsequent questionable behavior	8	21%
CEO resigns from other boards	3	8%

Note: Incidents of CEO misbehavior as reported in the news media between 2000 and 2015 based on keyword searches in Factiva. Days in the news represent the difference in time between the first and last article referencing the incident. Stock price reaction based on the 3-day market-adjusted stock price return including the day before, day of, and day following initial news article. Stock price reaction excludes privately held companies (six). Other board action includes actions taken by the board other than termination of the CEO, such as stripping the individual of chairman title, removing CEO from the board, amending corporate code of conduct, reducing or eliminating CEO bonus, other director resignations, and/or other changes in board composition. Other fallout includes additional actions taken by the company or stakeholders in response to the event, including changes in strategy or marketing strategy, loss of major clients, federal investigations, shareholder or federal lawsuits, or shareholder actions including proxy battle. Other unrelated governance issues include subsequent accounting restatements, lawsuits, shareholder actions, or bankruptcy. CEO resignations from other boards include only board resignations explicitly tied to issue.

Source: Research by the authors. Stock price information from the Center for Research in Securities Prices (CRSP), University of Chicago.